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IN THE

Supreme Court of the United States

October Term, 1971

No. 1763 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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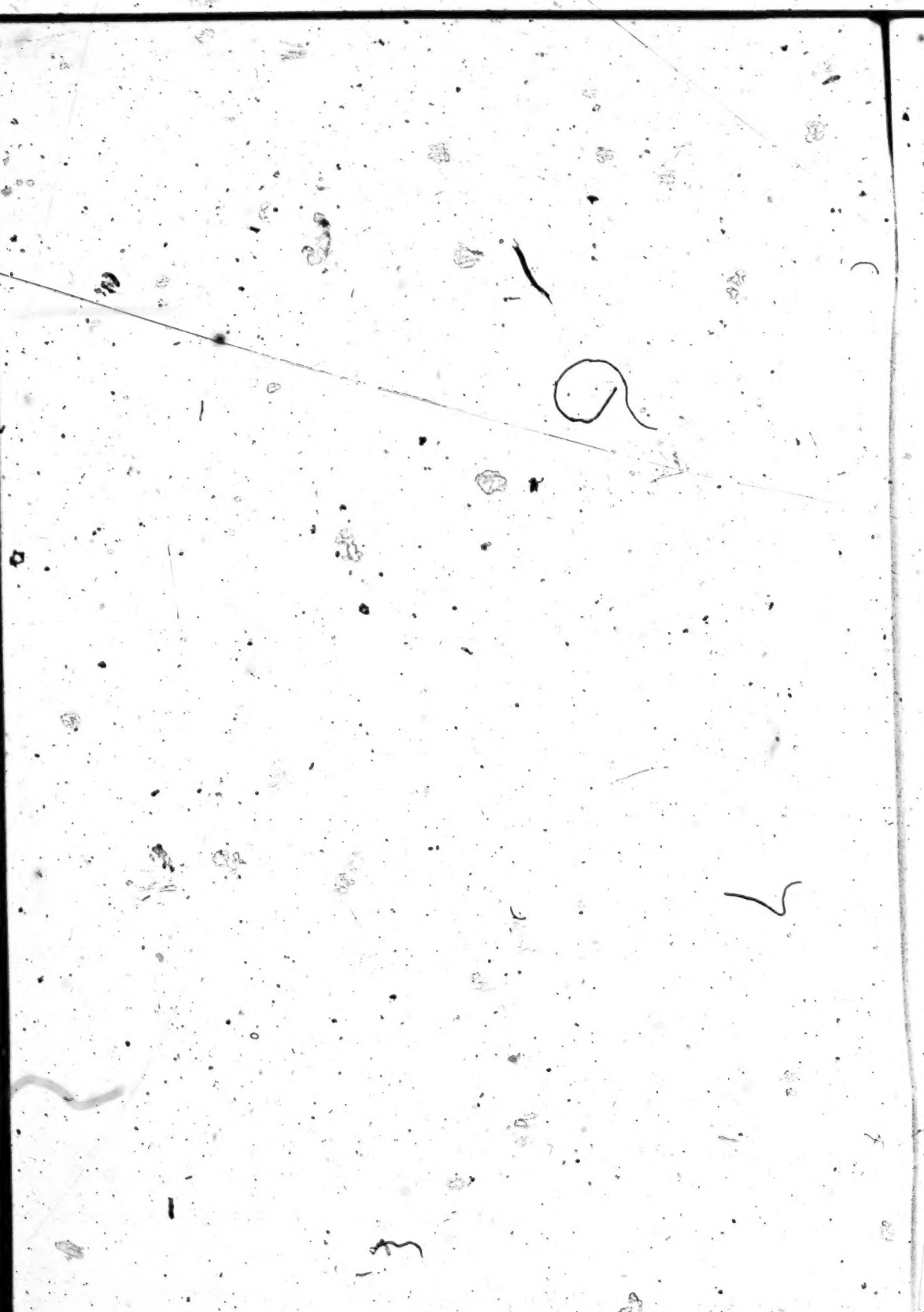

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No. .....

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered March 3, 1971.

Opinions Below

The opinion of the Court of Appeals is reported at 439 F.2d 118 (2d Cir. 1971). The opinions of the District Court have not been reported.

Jurisdiction

The judgment of the Court of Appeals was dated and was entered March 3, 1971. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Question Presented

Is the trustee in reorganization of a debtor pursuant to Chapter X of the Bankruptcy Act barred, as lacking standing or not being the real party in interest, from prosecuting a claim on behalf of the debtor's debenture-

holders against the indenture trustee for willful misconduct or gross negligence in failing to enforce covenants of the debtor contained in the trust indenture?

Statutes Involved

Pertinent portions of section 212 of the Bankruptcy Act and the Trust Indenture Act of 1939 are set forth in the appendix, *infra* at 29a.

Statement of the Case

Petitioner, the Chapter X Trustee of Webb & Knapp, Inc., seeks review of a judgment of the Court of Appeals holding that petitioner lacked standing to prosecute claims, on behalf of the holders of the debtor's debentures, against the respondent, which was the trustee of the debentures under a trust indenture dated June 1, 1954.

The claims sought to be asserted are grounded on respondent's failure to enforce a covenant in the indenture which prohibited the debtor from purchasing real property or incurring new indebtedness unless it maintained a defined asset-to-liability ratio of at least 200%. Each year the debtor submitted a certificate of its officers stating that no default had occurred, together with a statement purporting to show the asset-to-liability ratio as of the preceding December 31. Those statements, as permitted by the trust indenture, were based upon the value of the debtor's interest in real property as appraised by officers of the debtor, and the appraisals were submitted with the certificates.

Petitioner claims that the appraisals were false and fraudulent in that they were grossly inflated. Petitioner contends that at no time during the years 1958 to 1964 did the debtor maintain the required asset-to-liability ratio, but that the debtor, in violation of the trust indenture, purchased real property and incurred indebtedness throughout the period. Petitioner further claims that the inflated nature of the appraisals of the debtor's real prop-

erty was apparent on their face and that the increments in value of individual properties from year to year, as shown in the appraisals, were so enormous as to make them inherently suspect.[1]

In addition, the debtor, commencing with the appraisal for the year 1958 affixed a note to the appraisals that they represented the officers' "view as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established". Petitioner contends that the note put respondent on notice that the appraisals did not comply with the indenture and were inflated. Respondent, however, took no action to compel the debtor to comply with the indenture.

Respondent, by failing to prevent the debtor from purchasing property and incurring indebtedness, was guilty of willful misconduct or gross negligence, by reason of which the debenture holders were damaged. Petitioner claims damages of $4,298,200, the principal amount of the outstanding debentures.

Petitioner obtained authorization of the reorganization court to prosecute the claims by commencing a plenary action against respondent and in addition by filing an objection and counterclaim to respondent's proof of claim filed in the reorganization proceeding. Petitioner also sought an order in the reorganization court to compel respondent to account, so that a counterclaim could be asserted in the accounting proceeding.

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[1] Thus one major parcel of land of the debtor, designated as the Baychester property, was shown on the officers' appraisals as of December 31, 1957 as having a value of $15,000,000. The following year it was appraised at $27,000,000. The appraisal for 1959 was $64,000,000 and for 1963 it reached $91,000,000. There were no significant improvements to the land involved. During this period, the only changes which affected the Baychester property were the additions of land at a cost of $1,200,000 and the execution of a lease to Freedomland, Inc. of a large portion at an initial annual net rent of $600,000.

The District Court had jurisdiction of the action and the proceedings relating to respondent's proof of claim and to compel respondent to account under section 2 of the Bankruptcy Act, 11 U.S.C. § 11.

The District Court dismissed the complaint in the plenary action and the counterclaim to respondent's proof of claim. It also denied petitioner's petition to direct an accounting. It denied respondent's motion to strike the objection to its proof of claim, however.

Two of the three judges of the Court of Appeals before whom the consolidated appeals were heard would have reversed and overruled the earlier case of *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). The appeal was thereupon referred to the Court *in banc*, which, without hearing oral argument but relying solely on the briefs, affirmed the orders of the District Court, Judges Kaufman and Hays dissenting.

Reasons for Granting Writ

A. The legislative purpose of Chapter X and the Trust Indenture Act require that a reorganization trustee have standing to prosecute claims of debenture holders.

This case raises serious questions about the role of a Chapter X trustee in the prosecution of bondholder's claims against indenture trustees. The problem is a recurring one, and the cases are in conflict, as is more fully discussed below. At issue in this case are the rights of the holders of over $4,000,000 in face value of Webb & Knapp debentures. Moreover, the rights of the holders of billions of dollars worth of other bonds and debentures are directly affected.[2] A debtor which defaults in payment of publicly-

[2] During the ten-year period ending June 30, 1970, there were public offerings of debt securities in the United States which totaled $87 billion. The most recent four-year period showed a striking increase in the public issuance of such securities: $12 billion in fiscal 1967, $14 billion in 1968, $11 billion in 1969 and $18 billion in 1970. SEC, 36th Annual Report (1970) 215.

issued debt securities is more than likely to be placed in reorganization under Chapter X. The unsettled role of the reorganization trustee with respect to bondholder's claim can only be resolved by this Court.

The question is simply whether a claim for relief, on behalf of debenture holders, against an indenture trustee, may be prosecuted by the Chapter X trustee, or whether the debenture holders must be left to their own devices.

Actions by the individual debenture holders are difficult to prosecute because they, unlike the reorganization trustee, do not have ready access to the debtor's records and do not have the power to investigate given the Chapter X trustee by Section 167 of the Bankruptcy Act. The debenture holders, who may have unquestioned standing and be undoubted real parties in interest, are in fact unlikely even to know a claim for relief exists. This is particularly true where, as in this case, the indenture trustee represents the debenture holders in the reorganization proceeding.[3]

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[3] Debenture holders face a further problem in jurisdictions which follow the New York rule of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), *aff'd* 284 N.Y. 726. That case held that (1) a cause of action against an indenture trustee which does not involve a surrender or release of trust assets does not pass to the transferee upon assignment of the bond, and (2) a class action may not be prosecuted on such claims. Although the first aspect of the doctrine was changed by statute, now. New York General Obligations Law § 13-107, the prohibition against class actions remains uncertain. In *Lewis* v. *Marine Midland Grace Trust Co.*, New York Law Journal, June 28, 1968, page 12, col. 2, the *Elkind* Rule was followed in dismissing a class action brought by a Webb & Knapp debenture holder on the same claims as are in issue in this case. More recently *Elkind* was rejected in *Ray* v. *Marine Midland Grace Trust Co.*, New York Supreme Court, New York County, Index No. 2159-1967, January 8, 1971, appeal pending, an action by a different Webb & Knapp debenture holder.

The Chapter X trustee, on the other hand, is the logical person effectively to prosecute such an action. He possesses the records of the debtor, he has the knowledge gained from his examination, he possesses the facilities to conduct complex litigation, and he acts under the supervision of the reorganization court and the scrutiny of the Securities and Exchange Commission.

Whether a Chapter X trustee may prosecute such claims is a question which must be considered in the light of the function of a reorganization trustee and the purpose of the Chandler Act. As the leading commentator states:

> "Chapter X thus represents the present culmination of the long struggle to resolve the many legal, economic and social difficulties inherent in the search for a satisfactory procedure that achieves an equitable reorganization." 6 Collier on Bankruptcy ¶ 0.01.

One of the principal concerns of Chapter X is protecting the interests of the holders of the debtor's publicly held securities. The statute provides for active participation by the SEC. Bankruptcy Act, Sections 161, 167, 171-175, 179, 190, 208, 222 and 265, 11 U.S.C. §§ 561, 567, 571-574, 579, 590, 608, 622 and 665. The House Report on the Chandler Act stated:

> "It would be idle to provide that protective measures be adopted without likewise providing the means whereby such protection can be afforded. * * * There must be power and responsibility in the hands of a qualified representative of investors. * * * Investors must be afforded a 'focal point' for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest." H. Rep. 1409, 75th Cong., 1st Sess. (1937) 43-44.

Additional support for the petitioner's standing is found in the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.* That statute was enacted in response to

an SEC report which had shown that trust indentures typically were drafted to exculpate the indenture trustee from responsibility or liability, leaving bondholders without effective remedies. 2 Loss, Securities Regulation (2d Ed.) 719-725; and see, *e.g., Hazzard* v. *Chase National Bank,* 159 Misc. 57, 287 N.Y.S. 541, 569-570 (Sup. Ct. N.Y. Co. 1936), *aff'd* 257 App. Div. 950, 14 N.Y.S. 2d 147 (1st Dept. 1939), *aff'd* 282 N.Y. 652 (1940), *cert. denied* 311 U.S. 708. The statute itself expressly sets forth the reasons for the legislation, including the need to impose affirmative duties upon indenture trustees to protect investors, 15 U.S.C. § 77bbb(a)(2). It was declared to be the policy of the Act to eliminate the existing practices which were criticized, 15 U.S.C. § 77bbb(b). That policy is effected by, among other things, prohibiting exculpation of the indenture trustee "from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct" with exceptions for certain acts performed or omitted in good faith, 15 U.S.C. § 77ooo(d). Jurisdiction of actions to enforce liabilities created by the Act is given to district courts of the United States, 15 U.S.C. § 77vvv.

Just as private causes of action were created by Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), see e.g., *Fischman* v. *Raytheon Mfg. Co.,* 188 F.2d 783 (2d Cir. 1951); *Speed* v. *Transamerica Corp.,* 235 F.2d 639 (3d Cir. 1956), so the Trust Indenture Act has created causes of action. See *Kardon* v. *National Gypsum Co.,* 69 F. Supp. 512, 513 (E.D. Pa. 1946) ("The disregard of the command of a statute is a wrongful act and a tort.")

The claims which the Trustee seeks to enforce are thus created by an Act of Congress which, like Chapter X itself, is part of the overall legislative program to protect the investing public. It certainly was not the intent of Congress, after establishing new standards of conduct for indenture trustees, to leave no effective means for enforcing

them. The narrow construction of the Court below would frustrate legislation which was intended to have a broad remedial effect.

The question of standing of a reorganization trustee to sue on behalf of others has never been decided by this Court. The lower courts have considered the problem in a variety of contexts, but have not achieved consistent results, as is shown by the cases discussed at pages 12-16 *infra*. In one recent Chapter X proceeding, the reorganization trustee obtained a settlement on behalf of debenture holders against an indenture trustee which allegedly failed to enforce negative covenants of the debtor, *In the Matter of Continental Vending Machine Corp.*, (E.D.N.Y. 63-B663). There a settlement between the reorganization trustee and the indenture trustee, reached without litigation of the standing problem, was incorporated in the plan of reorganization. See Trustee's Report pursuant to section 167(5) of the Bankruptcy Act at 38-39 and discussion in SEC, 36th Annual Report (1970) 187. And see also *In the Matter of Dilbert's Leasing & Development Corp.*, (E.D.N.Y. 63-B-148), in which the Chapter X trustee settled an action he had commenced against the indenture trustee, the proceeds to be held for the debenture holders.

The question of a Chapter X trustee's standing to sue on Rule 10b-5 claims on behalf of security holders has been litigated in several cases. In *Mooney* v. *Vitolo*, CCH Bankruptcy Law Reporter ¶ 62,573 (S.D.N.Y. 1967), the trustee was held to have no standing to sue directors and others on behalf of stockholders, for manipulation of the price of the debtor's stock. In *Carpenter* v. *Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970), opinion on mandamus, *sub. nom. Ernst & Ernst* v. *United States District Court*, No. 30,097 (5th Cir. February 25, 1971), however, the district court found standing in an action based on Rule 10b-5 on the ground that the trustee, having settled certain claims against the debtor, became vested with the injured parties' rights by the state

law doctrine of indemnity. He was therefore a member of the injured class and a proper plaintiff to prosecute a class action on their behalf.

The decisions in *Mooney* and *Carpenter* were reached on the simple test of whether the Chapter X trustee himself owns a claim of the same nature as the claims of the class he seeks to represent. If so, he is a proper plaintiff under Rule 23 of the Federal Rules of Civil Procedure.[4] Such a rule is eminently reasonable for class actions brought by private parties, but where it is used to determine the standing of a Chapter X trustee, it becomes a sterile test. At the heart of all standing requirements is the concern that parties are adequately represented so that issues are clearly presented, *Flast* v. *Cohen*, 392 U.S. 83, 99-100 (1968). It is now well established that an organization may represent its members, *NAACP* v. *Alabama*, 357 U.S. 449, 458-459 (1958); *Curran* v. *Laird*, 420 F.2d 123 (D.C. Cir. 1969); *National Student Association* v. *Hershey*, 412 F.2d 1103, 1119-1121 (D.C. Cir. 1969). From the foregoing it follows that the major prerequisite of standing is met if the plaintiff demonstrates a sufficiently genuine interest in the issue to insure that the persons he represents are fully protected. This is certainly true of a reorganization trustee.

The Court below, finding no express authority in Chapter X permitting a reorganization trustee to prosecute claims against an indenture trustee, concluded that none existed. It searched the statute and found power in the trustee to act only in relation to "property" of the debtor. It rejected the argument that claims of debenture holders could be asserted by the Chapter X trustee as a counterclaim to an indenture trustee's account, despite the unqualified statutory power granted by section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an indenture trustee to account.

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[4] Even this mechanical rule was rejected in *Arnold* v. *Greene*, No. C-782 (D. Colo. 1970), interlocutory appeal denied, Misc. No. 506 (10th Cir. 1970), where the Chapter X trustee was held to have a claim on his own behalf, but could not represent other claimants.

In doing so, the Court declined to follow the rationale of *In re Solar Manufacturing Corp.*, 200 F.2d 327, 331-332 (3d Cir. 1952), *cert. denied* 345 U.S. 940 (1953). The *Solar* case held that the reorganization court had inherent power to compel an accounting, even absent the statutory grant in section 212, and that the Chapter X trustee had standing to counterclaim on behalf of debenture holders.

The Court below stated that if the petitioner were successful and recovered from Marine Midland, the latter would simply be subrogated to the debenture holders' claims and the estate would be unaffected. This mechanical logic overlooks the fact that Marine Midland can only be liable if it is found to be guilty of serious negligence or willful misconduct. Subrogation, however, is an equitable doctrine, and will not be allowed to a party guilty of inequitable conduct, *American Surety Company* v. *Bethlehem National Bank*, 314 U.S. 314, 317 (1941).

But even if permitted to subrogate after payment to the debenture holders, the indenture trustee would receive only the distribution to which general creditors are entitled. The effect on the reorganization would be substantial: the debenture holders, for practical purposes, would achieve the status of senior creditors. Thus the matter might well have a great effect in the administration of the debtor's estate. And it is not inconceivable that a settlement would be reached in which Marine Midland would waive any right of subrogation. At this stage the possibilities are speculative, but it can hardly be denied that the reorganization may be substantially affected by the prosecution of the claim against Marine Midland, and that is sufficient to confer standing.

The Court below expressed concern that the power sought to be exercised by the petitioner would permit him to settle the claims of debenture holders against third parties, or even partially or totally release such claims. Yet no settlement could be reached by the reorganization trustee without the approval of the reorgani-

zation court after notice to interested parties and upon consideration of the views of the SEC. These safeguards are fully as adequate as those contained in Rule 23 of the Federal Rules of Civil Procedure. As the dissent below pointed out, participation by the SEC is an important reason for permitting these claims to be litigated in the reorganization proceeding rather than in a bondholders' private class action.

The Court below would have permitted the indenture trustee to prosecute these claims on behalf of debenture holders had they involved "property" of the debtor. It did not acknowledge, however, that in such an action the very problem it was concerned about in the instant case would be equally present: the possible right of the indenture trustee to subrogate and the possible settlement of debenture holders' claims without their consent.

Indeed, the rationale of the Court below that these would be standing if the claims were based upon a mishandling by the indenture trustee of the debtor's "property" (in the narrowest sense), might result in a neater doctrine, but would play havoc with the rights of the debenture holders. The bare title to pledged property in which the debtor has no remaining equity provides no sturdier basis for standing than is present in this case. The underlying claims in either situation are for the benefit of a limited class, against an indenture trustee for violation of his trust. To permit the result to turn on whether "property" of the debtor is involved is to adopt as part of Chapter X fine issues of state law where there is no state interest at stake.

This case presents an opportunity for this Court to define the interrelated functions of Chapter X and the Trust Indenture Act, and the protection they afford to the investing public.

B. Review of the judgment below is required to resolve the conflict between circuits and within the Second Circuit.

The Court below found that petitioner lacked standing to assert the claims of debenture holders, relying on *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). *Clarke* was a plenary action by a reorganization trustee in which damages were sought against an indenture trustee. Dismissal of two counts alleging failure to enforce the debtor's covenants in the trust indenture was affirmed.

Clarke, however, is in direct conflict with the decision of the Court of Appeals for the Third Circuit in *In re Solar Manufacturing Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953). The *Solar* case upheld the standing of a Chapter X trustee to assert similar claims of debenture holders against an indenture trustee in counterclaims to the indenture trustee's proof of claim and to its account. Thus the ability of the debenture holders to have their claims prosecuted by a Chapter X trustee against an indenture trustee depends on the fortuitous circumstances of the circuit in which the debtor is being reorganized.

Moreover, as the dissenters below explicitly recognized, *Clarke* is also irreconcilable with the later decision of the Second Circuit in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert. denied* 346 U.S. 835 (1953), in which standing of the successor of a reorganization trustee to assert a similar claim by counterclaiming to the indenture trustee's account was upheld.

The majority below sought to distinguish the *Prudence-Bonds* case and dismissed with a footnote *In re Solar Manufacturing Corp.*, which it also found distinguishable. Petitioner believes the distinctions to be transparently lacking in substance.

In *Clarke* the reorganization trustee had commenced a plenary action against the indenture trustee on behalf of debenture holders. The first and third counts of the

complaint alleged that the indenture trustee had failed to prevent the debtor from engaging in certain transactions which were in violation of "negative pledge covenants of the indenture" 137 F.2d at 800. The Court of Appeals affirmed the dismissal of these counts because the claims were not part of the property of the debtor, but rather belonged to the debenture holders. In addition the Court stated that the reorganization trustee was barred because he had no title to the claims and was not the real party in interest, Rule 17(a) of the Federal Rules of Civil Procedure. Judge Learned Hand dissented vigorously.

The issue arose in a different procedural context in the *Solar* case. There the pertinent claim was that the debtor had sold its Chicago plant and had deposited the $450,000 proceeds in its general deposit account with the indenture trustee. The reorganization trustee claimed the indenture trustee to have been derelict in not earmarking the $450,000 for the debenture holders. The claim was asserted in counterclaims to the indenture trustee's proof of claim and to the indenture trustee's account which it had filed.

The Third Circuit held that the reorganization trustee had standing to prosecute the claims on behalf of the debenture holders. The Court acknowledged the similarity of the claim to the first and third counts of the *Clarke* complaint. It distinguished *Clarke*, however, holding that the summary jurisdiction of the reorganization court with respect to the indenture trustee's proof of claim and account provided a vehicle for adjudication which apparently was lacking in a plenary action, 200 F.2d at 332, n. 6.

The Court below rejected the procedural distinction made by the Third Circuit. Instead it distinguished *Solar* by dignifying as a holding the casual description by the *Solar* Court of the claim as "quasi in rem and for the benefit of the trust" and "for the restoration of trust funds." *Cf.* 200 F.2d at 332 with Appendix to this Petition 17a, note 4. That general description of the claim

had not been used by the *Solar* court itself to distinguish it from *Clarke,* however, and it is clear that the funds were never part of any trust. They were not delivered to the indenture trustee impressed with a trust, but as deposits in a commercial bank account. The only possible basis for recovery was the failure of the indenture trustee to enforce a negative covenant in the indenture.

Promptly on the heels of *Solar* came *Prudence-Bonds.* There the successor to the reorganization trustee (referred to as the "New Company"), in a counterclaim to the indenture trustee's account, asserted claims on behalf of debenture holders. The debtor in *Prudence-Bonds* had assigned three mortgages to the indenture trustee to secure a series of negotiable bonds which were issued to the public. The debtor had also deposited a guaranty, made by another corporation, of the mortgages held as security. One of the mortgagors defaulted, and although the guarantor was solvent at the time, the indenture trustee failed to enforce the guaranty. The guarantor subsequently became insolvent.

Judge Learned Hand, who had dissented strongly in *Clarke,* wrote the opinion on reargument. He acknowledged, 202 F.2d at 559, that there had been no "surrender or release" of trust assets, the touchstone for permitting a representative action under New York law. Judge Hand avoided the issue of whether claims against the indenture trustee passed upon transfer of the bonds by assuming that some of the bondholders at the time the cause of action arose continued to hold their bonds when the petition for reorganization was filed. That being so, the only question was whether they might be represented by the New Company. That depended, he said, upon whether the New Company was a proper party under Rule 17, made applicable to bankruptcy proceedings by General Order 37. An earlier order in the reorganization proceedings had provided that objections by the New Company to the accounts filed by the indenture trus-

tees (of whom there were many, on eighteen separate issues of bonds) should be deemed to have been made for itself and on behalf of bondholders. Judge Hand found this order to be within the authority granted to reorganization courts to effect and carry out plans.

Therefore, by reason of the order, which was within the statutory power of the court, the New Company became a "party authorized by statute" to "sue in his own name" under Rule 17(a), 202 F.2d at 560. Thus the *Prudence-Bonds* court found the claims to be a proper subject for resolution in a Chapter X proceeding, although *Clarke* had held flatly that such claims "have no place in a plan of reorganization," 137 F.2d at 800.

On the merits, the Court in *Prudence-Bonds* found the indenture trustee to be not liable because of exculpatory provisions of the indenture. In reaching this conclusion the court determined that the guaranty was a part of the trust *res*, for the purpose of interpreting the indenture. The majority below grasped at this to distinguish *Prudence-Bonds* from *Clarke*. In *Prudence-Bonds* the finding that the guaranty was part of the res was pertinent only on the merits. But the court below equated "*res*" with "property of the debtor", as to which the Chapter X trustee has unquestioned standing. The fact that property is part of a trust *res* held by an indenture trustee does not make it property of the debtor, and in *Prudence-Bonds* the guaranty was certainly not property of the debtor.

Moreover, the claim in *Prudence-Bonds* was not for surrender or release of the property, whether the debtor's or a third party's, as Judge Hand expressly stated. The claim was based upon the indenture trustee's failure to act to enforce the guaranty. That is exactly the category of claim sought to be prosecuted here.

The court below treated as a separate issue the status of petitioner under Rule 17, Federal Rules of Civil Pro-

cedure. It concluded that in the absence of express statutory authorization for a Chapter X trustee to prosecute such claims, petitioner was not a proper party. It rejected the contention that section 212 of the Bankruptcy Act, 11 U.S.C. § 612, granting power to compel an indenture trustee to account, was sufficient statutory authority to permit a Chapter X trustee to counterclaim to such an account. That was the rationale in *Solar*, and is less tenuous than the theory relied on in *Prudence-Bonds*.[5]

Left unstated by the Court below, as in *Clarke* and *Prudence-Bonds*, is the question whether, in the situation presented, there is any distinction between the issues of standing on the one hand and status under Rule 17 on the other hand. It would appear that a proper party under Rule 17 has standing, as was held in *Prudence-Bonds*, and that any party with standing is a proper party under Rule 17.

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[5] The order of the reorganization court in *Prudence-Bonds* permitted claims of bondholders to be pressed with respect to eighteen series of bonds. In a number of these the indenture trustees had surrendered or released property of the debtor, e.g. *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130 (2d Cir. 1939). It is therefore questionable whether the order was intended to grant any rights to the New Company which its predecessor, the reorganization trustee, did not possess. It is even more questionable whether the court had power to grant the New Company such additional rights. These doctrinal problems would not be present if an accounting were compelled pursuant to Section 212, to which the petitioner could counterclaim. In the present case, following the theory of *Prudence-Bonds*, the order of the District Court authorizing petitioner to prosecute the claims was, if within the Court's power, sufficient to make petitioner a proper party under Rule 17.

CONCLUSION

For the reasons set forth above, a writ of certiorari should issue to review the judgment of the Court of Appeals for the Second Circuit.

Respectfully submitted,

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APPENDIX

Opinion and Order of the District Court granting defendant's motion to dismiss the complaint in the plenary action

McLEAN, D. J.

Defendant has moved pursuant to rules 12(b)(6) and 17(a) to dismiss this action on the grounds that the complaint fails to state a claim and that plaintiff is not the real party in interests.

The complaint may be briefly summarized as follows: Plaintiff is the trustee of Webb & Knapp, Inc. (the Debtor), now in reorganization under Chapter X of the Bankruptcy Act. Defendant is trustee under a trust indenture executed by the Debtor with respect to an issue of 5 per cent debentures of the Debtor due in June 1974. Debentures in the principal amount of $4,298,200 are now outstanding. In the indenture the debtor made certain covenants "for the use and benefit of all the holders of the debentures." One of these provided that the Debtor would not incur certain types of indebtedness unless its tangible assets were twice its liabilities. Prior to the Debtor's bankruptcy, defendant, as indenture trustee, failed to enforce this covenant. Defendant accepted appraisals of the Debtor's property, delivered to it by the Debtor, which were false and fraudulent and which defendant knew or in the exercise of due diligence should have known were false and fraudulent. Defendant failed to prevent the Debtor from incurring additional indebtedness despite the fact that the Debtor's assets were not twice its labilities. As a result, the debenture holders have been damaged in the sum of $4,298,200 (the full face amount of the oustanding debentures). Plaintiff, "on behalf of" the debenture holders, seeks judgment in that amount.

Opinion and Order of the District Court granting defendant's motion to dismiss the complaint in the Plenary Action

The question is whether plaintiff, the Debtor's reorganization trustee, has standing to maintain this action on behalf of the debenture holders. *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), which is squarely in point, answers this question in the negative. The Court of Appeals there held that such a claim against an indenture trustee for failure to enforce a negative covenant made by the Debtor was a claim that is "personal to" the debenture holder. It held that the reorganization trustee had no title to the claim and could not maintain an action on it on behalf of the debenture holders. The order of the district court dismissing the action was affirmed, on the ground that the complaint did not state a claim and that the reorganization trustee was not the real party in interest.

This decision appears to be still the law in this circuit. I do not agree with plaintiff's contention that *Clarke* was overruled, *sub silentio*, by *Prudence-Bonds Corp.* v *State Street Trust Co.*, 202 F. 2d 555 (2d Cir. 1953).

Plaintiff relies on *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert. denied*, 345 U. S. 940 (1953), which reached a contrary result. The court in *Solar* purported to distinguish *Clarke* on the ground that in *Clarke* the reorganization trustee had asserted the claim in a plenary action (as he does in the present case), whereas in *Solar*, the claim was asserted by the reorganization trustee by way of a counterclaim to an account filed by the indenture trustee of its doings as such indenture trustee and to a proof of claim filed by the indenture trustee for its services.

In my opinion, the difference in the form of the proceeding does not require or permit a difference in result on the substantive issue of the standing of the reorganization trustee to seek affirmative relief. Unless the factual situation

in *Solar* can be said to be sufficiently different from that in *Clarke* to justify a distinction between the two cases on the merits, then the decisions in *Solar* and *Clarke* are in conflict.

Defendant argues that there is such a factual difference. This seems to me improbable, but it is unnecessary to decide that question. There is no distinction between *Clarke* and the present case, and if it be assumed that *Clarke* and *Solar* are conflicting, then it is the clear duty of this court to follow *Clarke* as the controlling decision in this circuit.

Plaintiff's contention that *Clarke* is wrong and that the dissenting opinion in that case presents the correct view is an argument which is not open to plaintiff in this court. Similarly, plaintiff's arguments based on matter of policy and upon the legislative history of the Bankruptcy Act are arguments which can properly be made only to the Court of Appeals. Only the Court of Appeals can decide whether or not *Clarke* is to be overruled.

Defendant's motions are granted. This action is dismissed.

So ordered.

Dated: May 20, 1968

EDWARD C. McLEAN
U. S. D. J.

Opinion of the District Court granting the motion to dismiss petitioner's counterclaim and denying motion to strike the petitioner's objection to the proof of claim

McLEAN, D. J.

This motion by Marine Midland Grace Trust Company of New York (Marine Midland) involves the question which was presented by defendant's motion to dismiss the action entitled *Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York,* 67 Civ. 1914, a motion which I have granted by opinion filed today.

Caplin v. *Marine Midland* was a plenary action which the reorganization trustee of the debtor sought to maintain on behalf of debenture holders to recover damages which the debenture holder allegedly suffered by reason of the failure of Marine Midland, as indenture trustee, to enforce a negative covenant made by the debtor for the benefit of the debenture holders. The nature of this covenant is explained in the Caplin opinion. That explanation need not be repeated here.

In the present case the same question has been raised in the Chapter X reorganization proceeding of the debtor. Marine Midland filed a proof of claim in the Chapter X proceeding in the sum of $51,447.55 for compensation for its services as indenture trustee. The reorganization trustee of the debtor subsequently filed an "objection" to this claim. The reorganization trustee took the position that Marine Midland is not entitled to compensation as indenture trustee because it failed to enforce the negative covenant. The allegations of this objection are substantially identical with those of the complaint in the *Caplin* action.

In addition, the reorganization trustee realleged all these allegations as a counterclaim "on behalf of the holders of the outstanding debentures" to recover damages in the sum of $4,298,200 which the debenture holders have alleg-

edly suffered by reason of Marine Midland's failure to enforce the negative covenant.

Marine Midland now moves to dismiss the counterclaim on the same grounds upon which it moved to dismiss the *Caplin* action, *i.e.*, that the counterclaim fails to state a claim and that the reorganization trustee is not the real party in interest, plus the additional ground that the bankruptcy court does not have summary jurisdiction to determine the counterclaim. Marine Midland also moves to strike the objection on the ground that it is "an insufficient defense to Marine Midland's proof of claim."

The motion addressed to the counterclaim must be granted. As is pointed out in the court's opinion dismissing the *Caplin* action, *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), a decision binding upon this court, held that a reorganization trustee has no standing to maintain a plenary action on behalf of debenture holders to recover damages allegedly sustained by them by reason of the failure of an indenture trustee to enforce a negative covenant made by the debtor for the benefit of the debenture holders. It necessarily follows that the reorganization trustee has no standing to seek precisely the same affirmative relief, on the same grounds, by way of counterclaim. According to *Clarke*, it is the debenture holders, not the reorganization trustee, who own the claim and hence it is only the debenture holders who may sue on it. To the extent that *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert denied*, 345 U. S. 940 (1953), drew a distinction between enforcing a claim by independent action and enforcing it by counterclaim, I do not feel at liberty to follow that decision.

Opinion of the District Court granting the motion to dismiss Petitioner's counterclaim and denying motion to strike Petitioner's objection to the proof of claim

In view of this conclusion it is unnecessary to consider the separate question as to whether the bankruptcy court has summary jurisdiction over the counterclaim.

The reorganization trustee's "objection," which in substance amounts to an alleged affirmative defense to Marine Midland's proof of claim, presents a different situation. In opposing Marine Midland's claim, the reorganization trustee is acting, not solely on behalf of the debenture holders, but on behalf of all persons interested in the estate. In this instance Marine Midland is not defending itself against a claim asserted against it on behalf of the debenture holders. It is seeking to recover money for itself. The services for which Marine Midland asks compensation were services rendered by it for the benefit of the debenture holders. Marine Midland's claim necessarily presupposes that it has fully performed its obligations to the debenture holders. If it has not, if it has failed to protect their interests in the manner required by the indenture, it would not be entitled to compensation from the debenture holders.

Marine Midland seeks to recover compensation in this instance from the estate, rather than from the debenture holders, because the indenture provides that the debtor will pay the trustee's compensation for its services. But if Marine Midland is not entitled to compensation from the debenture holders because of its nonperformance of its obligations, it follows that it cannot recover from the debtor either. Thus, Marine Midland's alleged nonperformance is a valid defense, on its face, to Marine Midland's claim.

Marine Midland is attempting to enforce its claim against the debtor's estate. The reorganization trustee, who represents the estate, has standing to resist the claim. If its resistance turns out to be successful, all persons interested

Opinion of the District Court granting the motion to dismiss petitioner's counterclaim and denying motion to strike petitioner's objection to the proof of claim

in the estate, not merely the debenture holders, will benefit. *Clarke* does not apply in this situation.

There can be no question, nor does Marine Midland raise any, about the jurisdiction of the bankruptcy court to determine claims against the debtor's estate.

Marine Midland's motion to dismiss the reorganization trustee's counterclaim is granted. Its motion to strike the reorganization trustee's objection is denied.

Settle order on notice.

/s/ EDWARD C. McLEAN
U. S. D. J.

Dated: May 20, 1968

Opinion of the District Court denying petitioner's motion to compel an accounting

McLEAN, D. J.

By order No. 100 dated April 27, 1967, this court granted the application of the trustee of the Debtor to begin a plenary action against Marine Midland Grace Trust Company of New York (Marine Midland), trustee under an indenture relating to 5 per cent debentures of the Debtor due June 1, 1974, to recover damages allegedly sustained by the debenture holders by virtue of Marine Midland's failure to enforce a negative covenant contained in the indenture. The order also authorized the Debtor's trustee to assert the same claim against Marine Midland by way of counterclaim to the claim filed in the reorganization proceeding by Marine Midland for compensation for its services as indenture trustee. The court reserved decision upon a third application made by the Debtor's trustee at that time, an application to require Marine Midland to account to this court for its acts as indenture trustee.

Thereafter the Debtor's trustee began the plenary action, entitled *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York*, 67 Civ. 1914. The Debtor's trustee also asserted the same claim by setting up a counterclaim to the proof of claim for compensation filed by Marine Midland in the reorganization proceeding. Marine Midland moved to dismiss both the plenary action and the counterclaim. By opinions dated May 20, 1968, the court has granted those motions on the authority of *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943). The court permitted the Debtor's trustee, however, to assert the claim as a defense to Marine Midland's claim for compensation.

This memorandum is devoted to the question as to which decision was previously reserved, *i.e.*, whether Ma-

rine Midland should now be required to account. Assuming that the court has power to make such a direction, the court sees no valid reason for exercising that power at this time.

Marine Midland is still acting as indenture trustee for the debenture holders. It has filed a proof of claim on their behalf in the reorganization proceeding. It has not resigned, nor has it indicated any intention or desire to resign.

There is no claim here that Marine Midland has in any way mishandled any funds which have come into its hands as indenture trustee. The only claim which the Debtor's trustee has asserted against it is that in the years prior to the Debtor's bankruptcy, it failed to enforce the negative covenant in the indenture. It is apparent that the real reason why the Debtor's trustee requests that Marine Midland be required to account is the fact that the Debtor's trustee believes that he might have standing to assert this claim as a counterclaim to an account, even if he has no standing to assert it by a counterclaim to Marine Midland's claim for services or by independent action.

> *See In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3rd Cir. 1952), *cert. denied*, 345 U. S. 940 (1953)

This belief is not well founded, as long as *Clarke* continues to be the law in this circuit. Since the reorganization trustee has no title to the claim of the debenture holders for damages for the nonperformance by Marine Midland of its duty to enforce the negative covenant, the Debtor's trustee, under the *Clarke* rule, may not sue on that claim. It can make no difference that affirmative relief is sought by counterclaim rather than by independent action, or that the counterclaim is interposed to an account rather than to a claim for services. Hence to require an account from

Opinion of the District Court denying petitioner's motion to compel an accounting

Marine Midland would not accomplish the purpose which the Debtor's trustee has in mind.

It is suggested that Marine Midland's personal interest is in conflict with the interest of the debenture holders. This amounts to a claim that Marine Midland should be removed as indenture trustee, although no such relief is requested in the moving papers.

The suggestion of conflict of interest seems to the court to be far-fetched. Marine Midland initiated this Chapter X proceeding. It asserts that it has acted throughout in accordance with its obligations under the indenture. Obviously, there is no conflict between this position and its continued representation of the bondholders. And even if this court should eventually sustain the Debtor's trustee's objection to Marine Midland's claim for compensation on the ground that Marine Midland failed to enforce the negative covenant prior to the Debtor's bankruptcy, it does not necessarily follow that Marine Midland cannot properly represent the debenture holders in the reorganization proceeding. It would be unjust to remove Marine Midland merely because an objection has been made to its conduct prior to the bankruptcy, an objection which as yet has not been proved. The court sees no probability of injury to the bondholders by permitting Marine Midland to continue to represent them in the meantime, at least until that question is resolved.

Accordingly, the Debtor's trustee's motion to compel Marine Midland to account is denied.

Settle order on notice.

Dated: May 22, 1968

EDWARD MCLEAN

U.S.D.J.

Opinion of the Court of Appeals

Before:

LUMBARD, *Chief Judge,*
MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS
and ANDERSON, *Circuit Judges.**

FRIENDLY, *Circuit Judge*:

We have three appeals and a cross-appeal from orders of Judge McLean concerning the reorganization of Webb & Knapp, Inc. under Chapter X of the Bankruptcy Act which is now pending in the District Court for the Southern District of New York. All relate to complaints by the Chapter X Trustee, Mortimer M. Caplin, concerning alleged failure on the part of The Marine Midland Grace Trust Company of New York ("Marine"), trustee under an Indenture whereunder Webb & Knapp issued unsecured debentures now outstanding in the amount of $4,398,200, to enforce certain covenants made by the debtor.[1]

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* Judge Feinberg took no part in the consideration or decision of this case.

[1] The breach concerns mainly, if not indeed solely, Section 3.6 of the Indenture. Webb & Knapp there covenanted that so long as any of the debentures remained outstanding, it would not incur or assume indebtedness resulting from borrowings or from the purchase of real property or interests in real property on which it would be personally liable, or to purchase any real property, or interests in real property, unless on the basis of computations (made as of the last day of the fourth month prior to such transaction) its "consolidated tangible assets" would equal 200% of certain liabilities. In determining "consolidated tangible assets" the Company was authorized, *inter alia,* to rely on and use appraisals made by its officers and approved by the Board of Directors "of real property, of interests in real property . . . or of the controlling stock interest in any corporation the principal assets of which consist of real property or interests in real property." The Company was required to file a certificate of compliance annually with Marine. In addition to such certificates Marine requested, as permitted by the

Marine had filed a proof of claim in the sum of $51,447.55 for services rendered and expenses incurred by it as indenture trustee. The Chapter X Trustee objected to this on the ground of Marine's alleged breach of duty and counterclaimed for damages in the amount of the debentures that remained outstanding. With the authorization of the district court, he also filed a plenary suit seeking the same relief. In addition he moved that Marine be required to file an accounting. Marine moved to dismiss the objections to its proof of claim, the counterclaim and the plenary suit. The judge held that grant of Marine's motions to dismiss the counterclaim and the complaint was required by *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943), but denied its motion to dismiss the objections. He also denied the Trustee's motion to compel Marine to account since there was no allegation that Marine had mishandled any funds which came into its hands as indenture trustee, and the only claim asserted by the Chapter X Trustee was the indenture trustee's alleged failure to enforce the negative covenant, a claim that would stand no better as a counterclaim to an accounting than as a plenary action or as a counterclaim to a proof of claim. Each party appealed from the decisions adverse to it.

After a panel consisting of Judges Moore, Kaufman and Hays had come to the conclusion that *Clarke* should be overruled, the court voted, in accordance with its usual practice in such cases, see e.g. *Indussa Corp.* v. *S.S. Ran-*

Indenture, and received separate officers' certificates stating specifically that Webb & Knapp was not in violation of §23.6. In accordance with § 315 of the Trust Indenture Act of 1939, 15 U.S.C. § 77ooo, § 10.1 of the Indenture required Marine to examine all reports furnished to it but authorized it, in the absence of bad faith, to rely upon certificates or opinions conforming to the requirements of the Indenture. The Chapter X Trustee claims that although the reports for 1959-63 showed asset-liability ratios ranging from a high of 258.30 in 1961 to a low of 200.56 in 1963, Marine should have known that the appraised values were inflated.

org, 377 F.2d 200 (2 Cir. 1967), to consider the appeals *in banc* upon the briefs already filed. A majority of the full court have concluded that *Clarke* was correctly decided and, since this case is admittedly not distinguishable, that the dismissal of the counterclaim and the plenary suit should be affirmed. We are all of the view that the orders denying the Trustee's motion to require Marine to account and refusing to strike his objections to Marine's claim should be affirmed.

Clarke was an action by the Chapter X Trustee of Associated Gas and Electric Company (Ageco) against the Chase National Bank, trustee under an indenture for debenture holders. Broadly speaking the complaint contained two differing sets of counts. The first and third alleged that Chase, in breach of its duties as indenture trustee, had failed to enforce certain covenants against the mortgage or pledge of Ageco's property or its merger into another corporation and sought to recover losses suffered by the debenture holders in consequence. The second count sought recovery of $4,000,000 allegedly received by Chase from Ageco in payment of an indebtedness, though Chase knew the latter was insolvent or in imminent danger of insolvency; the fourth count alleged that Chase had received a preference in respect of $4,249,000 of Ageco debentures owned by Chase, through an unfair exchange with Ageco's subsidiaries of these debentures for securities of greater value, at a time when Chase knew Ageco was insolvent.[2] The court unanimously reversed an order dismissing the second and fourth counts. A majority, with Judge Augustus N. Hand writing for himself and Judge Chase, upheld an order of a different judge dismissing the first and third counts; as to this Judge Learned Hand dissented.

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[2] A fifth count sought to recover $40,000 that had been paid Chase as trustee's fees, which the district court had dismissed with leave to amend; the court dismissed the appeal from this order for lack of appellate jurisdiction, 137 F.2d at 801.

The majority in *Clarke* reasoned that, assuming liability, "we cannot see that the claims for breach of the covenants are any part of the property of the bankrupt or would affect the plan of reorganization"; they were rather claims "of the debenture-holders not derived from the bankrupt's estate but arising through the alleged tortious action of the indenture trustee." 137 F.2d at 800. They cited the earlier decisions in *In re 1775 Broadway Corp.*, 79 F.2d 108 (2 Cir. 1935), that the reorganization court has no jurisdiction to force nonassenting noteholders to release claims against an indenture trustee for misrepresentation in the sale of the notes, since these were not claims against the debtor or its assets or claims that must be settled to bring property into the reorganized company, and in *In re Nine North Church Street, Inc.*, 82 F.2d 186 (2 Cir. 1936), that the reorganization court has no jurisdiction to enjoin nonassenting certificate holders from suing the guarantor of a mortgage on the debtor's property since the suit was to enforce a personal right against the guarantor and did not concern property subject to reorganization. Judge Learned Hand argued that the indenture trustee had a duty to prevent the violation of the covenants in the indenture, 137 F.2d at 802, which was true enough, and then asked "In what way does that [breach of duty] differ from allowing a debtor, in violation of the mortgage, to substitute improper collateral?". The answer was that in the latter case the mortgage trustee would have dealt improperly with property of the bankrupt. Judge L. Hand himself had based his opinion in *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2 Cir. 1939), on the ground that there the accounting dealt with property of the debtor which trustees for secured creditors had allegedly surrendered in breach of the trust, and that the rights of the creditors to compel them to restore the *res* was within the "extended"

concept of the debtor's property in a reorganization.[3] He was there careful, however, to distinguish the case in which the creditors asserted rights having "nothing to do with the *res* and [which] would not restore it" and "had nothing to do with anything that had ever been the debtor's property, or with the distribution of any part of it." *Id.* at 132. This distinction, apparently lost sight of in his dissent in *Clarke,* had been further developed by Judge Frank in *Brooklyn Trust Co.* v. *Kelby,* 134 F.2d 105, 110-12, 116 (2 Cir.), *cert. denied,* 319 U.S. 767 (1943).

A year and a half after *Clarke,* a panel consisting of the three other judges of the court as it then stood, Swan, Clark and Frank, decided the complicated case of *President and Directors of Manhattan Co.* v. *Kelby,* 147 F.2d 465 (2 Cir. 1944), *cert. denied,* 324 U.S. 866 (1945). The unanimous opinion was written by Judge Frank, who had long been expert in reorganization matters and was a member of the SEC when Chapter X was adopted, in no small measure at its instance. The court took a broad view of the rights of reorganization trustees against a trustee under an indenture but stopped when it came to an issue similar to that here presented. One of the claims of the Chapter X Trustees was that the indenture trustee was liable in damages for failing to enforce a covenant of Prudence-Bonds Corporation to deposit a guarantee by the Prudence Company. Although recognizing that such damages might be considerable, the court held that "an action for those damages is not one for restoration of the [trust] fund" and "cannot be maintained in connection with the bankruptcy proceedings," 147 F.2d at 478, citing *Brooklyn Trust Co.* v. *Kelby, supra,* 134 F.2d at 111.

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[3] The "extension" was that in some instances the Chapter X trustee may be able to recover property of the company which the debtor, because it might be barred by a defense of consent or estoppel, could not. See *McCandless* v. *Furland,* 296 U.S. 140, 159-61 (1935).

It is with this background that we come to *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555, 558 (2 Cir.) *cert, denied*, 346 U.S. 835 (1953), more particularly to Judge Learned Hand's opinion on rehearing. The Chapter X Trustee regards this as fundamentally inconsistent with *Clarke*, which the opinion did not mention. In our view the reason for failing to mention *Clarke* was that for grounds clearly stated by Judge Hand, there was no inconsistency.

The holdings in *Prudence-Bonds* with which we are concerned were (1) that the Chapter X Trustees could have maintained an action against an indenture trustee for failure to enforce a "Secondary Guaranty" by the Prudence Company of mortgages held by the indenture trustee as security for the bondholders, and (2) that this right had been conveyed to the reorganized company. Indeed it is only the first holding that is of real interest here. Its justification was thus stated, 202 F.2d at 561:

> But by the Secondary Guaranty the Guarantor became a surety for the performance of the mortgagors, just as the mortgages were a surety for the same performance. The only difference between them was that in one case the security was the promise of a third person and in the other it was a lien upon property. The promise was a part of the *res* in precisely the same sense that the promises were in the policies of fire and title insurance, mentioned in Article 1, §2. As we have said, it was in effect the equivalent of a policy of credit insurance of the mortgagors.

The significance of this was heightened by the distinction drawn between the indenture trustee's failure to enforce the "Secondary Guaranty" and the "Primary Guaranty," i.e., a guarantee by the Prudence Company of the bonds of Prudence-Bonds themselves. While the court said it

"need not answer" the question whether this "was also a part of the *res*," the opinion in effect did so when it said that this "was a promise to pay the Debtor's obligations, and had nothing to do with the *res*." *Id.* It was the Primary Guaranty which was like the claim sought to be pressed in *Clarke* and here.[4] Far from being indistinguishable, as the dissent claims, *Prudence-Bonds* differs from this case and from *Clarke* on the very ground Judge Hand was at such pains to clarify. If Marine had held property of Webb & Knapp through pledge or, for example, as a result of payments into a sinking fund, the Chapter X Trustee could sue under *Prudence-Bonds* for mismanagement of such assets, since he would be asserting a claim to property of the debtor which the indenture trustee had held. Here, as in *Clarke*, he is not. The difference between failure to enforce a third party's guaranty of a mortgage assigned to an indenture trustee or other property held by it as security and failure to enforce a promise by the debtor is the highly significant one that the former has diminished the debtor's estate and the latter has not.

The collapse of the argument of the Chapter X Trustee based on *Prudence-Bonds* does not, of course, mean that we could not overrule *Clarke* if we were convinced that Judges Augustus Hand and Chase had been in error. But we are not.

It is necessary in the first instance to consider what effect a recovery by the Chapter X Trustee would have

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[4] We do not regard *In re Solar Mfg. Corp.*, 200 F.2d 327 (3 Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953), as in conflict with *Clarke*. Although we would not be persuaded by the procedural distinction made at p. 332 n. 6, the counterclaim against the Indenture trustee there sustained was for failure to earmark $450,000 it had received upon the sale of certain of the debtor's property. Since the claim was for failure to keep funds of the debtor which the indenture trustee was bound to hold in trust, the court concluded that the cause of action was "quasi in rem for the benefit of the trust" and "for the restoration of trust funds." *Id.* at 332.

on the reorganization. On a superficial view this might seem substantial—if, for example, the Chapter X Trustee were to achieve a complete recovery, the debenture holders would be paid off and it might seem there would be that much more for the other creditors and the stockholders. But this pleasant prospect speedily evaporates when the law of subrogation is brought into play. As a result of subrogation, Marine would simply be substituted for the debenture holders as the claimant. Cf. ALI, Restatement of Security §141 (1941). If the Chapter X Trustee recovered judgment in a lesser amount, the claim of the debenture holders would still be provable in full, with the division of the proceeds between them and Marine dependent upon the results of the reorganization, and other creditors or stockholders would not be affected. Indeed, even these hypotheticals put the case too favorably for the Chapter X Trustee, since we do not see the answer to Judge A. N. Hand's observation in *Clarke, supra,* 137 F.2d at 800.

> Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants.

The claim against Marine thus could not be prosecuted to judgment until the results of the reorganization become known.[5]

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[5] Caplin argues that failure to allow suit by him would leave the debenture holders without remedy against Marine as a practical matter, since under *Elkind* v. *Chase Nat'l Bank,* 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept.), *aff'd* 284 N.Y. 726 (1940), each would have to sue individually. Apart from other possibilities under F.R. Civ. P. 23, we would not regard it as unlikely that a class action could be maintained in federal court for violation of § 315 of the Trust Indenture Act of 1939, although, of course, we are not to be understood as so deciding.

Equally important to the *Clarke* decision was the necessity, 137 F.2d at 801, under F. R. Civ. P. 17(a), here applicable by virtue of General Order in Bankruptcy 37, that "Every action shall be prosecuted in the name of the real party in interest." To determine whether Caplin has that status, we look to the Bankruptcy Act.

Sections 186 and 187 provide that a Chapter X trustee "shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor." Section 70a vests a trustee appointed under §44 "with the title of the bankrupt" to eight types of property therein described. None of these, by the remotest stretch of language or even of imagination, could include the claims of debenture holders against an indenture trustee for permitting the debtor to violate covenants made by the debtor to the indenture trustee for the bondholders' protection. The bankruptcy trustee's task is to "collect and reduce to money the property of the estates for which they are trustees," §47. While the reorganization trustee's added duty, §167(3), to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate," may be broad enough to authorize him to report whether in his opinion an indenture trustee has failed in its duties to debenture holders and this may assist the latter in asserting their rights, nothing in the statute allows him to collect any moneys or other property not owed to or owned by the estate although, as indicated, see fn. 3, he may sometimes be able to recover an insolvent corporation's property when the corporation itself might be subject to a defense of consent or estopped.

Any other view would, for example, allow a Chapter X Trustee to settle claims of debenture holders against third parties with the approval of the reorganization court, and would, in principle, sanction a plan of reorganization providing for a partial or even total release of such claims. Yet §216(2) says that the plan "may deal with all or any part *of the property of the debtor*" (emphasis supplied) and §216(13) directs that it "may include provisions for settlement or adjustment of *claims belonging to the debtor or to the estate*" (emphasis supplied). The debenture holders' claims against Marine simply do not fit under those rubrics.

The Reorganization Trustee relies heavily on statements from the legislative history of Chapter X, such as that in the House Report, H.R. Rep. 1409, 75th Cong., 1st Sess., pp. 43-44 (1937), that "There must be power and responsibility in the hands of a qualified representative of investors." It was exactly in this spirit that Chapter X was read in its early years by the judges who sat on this court in the 1940's, one of whom, as noted, had played no small role in its enactment. These were not judges who read statutes in the niggling way condemned by Mr. Justice Holmes, "We see what you are driving at, but you have not said it, and therefore we shall go on as before." *Johnson* v. *United States*, 163 F. 30, 32 (1 Cir. 1908). But they could find nothing in Chapter X, as we cannot, to indicate that Congress was "driving at" allowing a trustee to enforce claims not belonging to the estate. Now that the issue has again been raised after so many years, Congress may wish to consider whether it is possible and, if so, desirable to go further and permit the trustee to enforce individual claims of security holders against third parties.[6]

[6] An affirmative answer should not simply be assumed. Apart from possible question whether the bankruptcy power extends to claims of creditors against solvent third parties, which Congress might not think it worthwhile to raise, there would be serious prob-

That is a policy decision to be made by the legislature, not by our overruling soundly reasoned decisions of our distinguished predecessors, who knew the statute every bit as well as we do and construed it to mean what it rather clearly says. We therefore affirm Judge McLean's dismissal of the Chapter X Trustee's counterclaim and plenary suit.

We are all in accord with the decision of the panel to affirm the district court's denial of the Trustee's motion for an accounting. Although §212 gives the reorganization court power to enforce an accounting under instruments whereby anyone of a number of persons, including an indenture trustee "purports to represent any creditor or stockholder," this does not authorize the court to require an "accounting" by an indenture trustee when there is no claim that he holds property belonging to the debtor or any security holder, or has mishandled any such property in the past.

We likewise are in accord with the panel's decision affirming the denial of Marine's motion to strike the Chapter X Trustee's objections to its proof of claim. Marine claims it is entitled to be paid its pro-rata share out of the debtor's property for services it rendered as the indenture trustee, whereas Caplin contends it did not perform the services

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lems if other states have rules like that prevailing in New York before 1950 that transfer of a bond does not carry accrued claims against trustees or guarantors. See *Elkind* v. *Chase Nat'l Bank, supra,* 259 App. Div. 661, 20 N.Y.S.2d 213, *overruled in part by statute,* L. 1950 c. 812 N.Y. Personal Property Law § 41, 4, contrast, *Welch* v. *Northern Bank & Trust Co.,* 100 Wash. 349, 170 P. 1029 (1918), or when such claims had been reserved by agreement. With no showing that the *Clarke* decision had caused any real difficulty over the past twenty-seven years, Congress might well decide that it was best to adhere in the policy of allowing holders of the bonds of debtors in reorganization to pursue their own remedies against third parties.

it should have performed. We cannot say that the objection, if well founded in fact, would not be valid in law. As already indicated, even though the debtor corporation here might have been estopped to assert failure of consideration as a defense to the trustee's claim, as Marine argues, it does not follow that the reorganization trustee may not do so.[7]

The orders of the district court are affirmed. No costs.

KAUFMAN, *Circuit Judge* (with whom Judge Hays concurs), dissenting in part:

I see no justification for continued adherence to the long since eroded rule announced over Judge Learned Hand's vigorous dissent in *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943). I would permit Caplin to assert his counter-claim and maintain the plenary action.

Indeed, Judge Hand himself in effect announced the demise of the *Clarke* rule in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), without saying so expressly. The plaintiff in *Prudence-Bonds*, like Caplin, sought redress on behalf of bondholders for the alleged default by the trustee of a bond indenture. The reorganized corporation, successor to the reorganization trustee and proceeding pursuant to an order of the bankruptcy court, alleged that the indenture trustee had negligently failed to demand payment by a guarantor of a mortgage pledged to the indenture trustee as security for the bonds, following the mortgagee's default. Although at the time of the default and for a period thereafter the guarantor was solvent and presumably could have made good on its guarantee, the guarantor's insolvency followed close upon that of the debtor. Learned Hand, joined by

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[7] We need not consider whether a determination of the objection in favor of the Chapter X Trustee might enure to the benefit of the debenture holders in an action by them under the principle of *Zdanok* v. *Glidden Co.*, 327 F.2d 944 (2 Cir.), *cert. denied*, 377 U.S. 934 (1964).

Chief Judge Swan and Judge Frank, found that the broad authority of the reorganization court to implement a reorganization plan furnished ample authority for the newly reorganized corporation to assert before the bankruptcy court the liability of the indenture trustee "to the bondholders for any loss that resulted" from that trustee's alleged breach. *See* 11 U.S.C. §§621-29.

In its brief on appeal, Marine attempted to distinguish *Prudence-Bonds* in several respects, but each is inconsequential. The relevance of the assertion that Marine successfully opposed Caplin's application for an accounting by Marine or that Marine is not now seeking a release as trustee, escapes me altogether. Such considerations would seem to bear more on jurisdiction than standing. And the claim that the bondholders' interests here are unsecured, unlike those in *Prudence-Bonds*, is also of no moment. Moreover, I would not attribute to Congress the perverse purpose of permitting a bankruptcy court to authorize a corporation already reorganized to assert bondholders' claims against the indenture trustee, as in *Prudence-Bonds*, while denying it the power to dispose of those claims in more orderly fashion by permitting the trustee to raise them *before* the reorganization plan has jelled.

The majority concedes that *Prudence-Bonds* is indistinguishable in any of these respects, but suggests that it may be explained away on yet another ground. The opinion tells us that a Chapter X trustee may proceed against an indenture trustee for failure to enforce a guaranty *by a third party* that secures the trust res, as in *Prudence-Bonds*, but not for failure to enforce a promise *by the debtor himself* contained in the trust indenture, as here, which also protects and secures the trust res. This anomalous result is said to be forced upon us because of language in Learned Hand's *Prudence-Bonds* opinion having nothing to do with that court's discussion of the standing problem.

But when a hypothesis as to a law's meaning is seen to yield such awkward conclusions, it is perhaps better to re-examine the hypothesis than to ascribe to Congress an intent to fashion so irrational a design. In this instance, the pressure to ascribe such an intent is very slight indeed. For in purporting to set forth the reasoning of the *Prudence-Bonds* court with respect to the standing problem, 202 F.2d 555 at 560, the majority relies entirely on dictum which occurs in the court's later analysis of the merits of the successor corporation's action against the trustee. 202 F.2d at 561. The finding of standing in *Prudence-Bonds* is not premised at all on this dictum, but rather "on the broad implementary powers of a judge when a plan is confirmed" and specifically on an order of the reorganization court permitting the new corporation to pursue "*any* objections" (emphasis added) to the indenture trustee's accounts "on its own behalf and on behalf of" the bondholders. There is no basis in the *Prudence-Bonds* opinion for limiting this language, which clearly would comprehend such an action as Caplin's, by transposing into the court's discussion of standing later dictum intended to bear—and even then incidentally and by way of speculation and musing—only on the merits of the new corporation's action, and not on its right to bring it.

In distinguishing *Prudence-Bonds* the majority is compelled to rely on dictum in the opinion irrelevant to the question presently before this court. But, we can understand this, for otherwise the majority would be required to show in detail why there should have been standing in *Prudence-Bonds* under the rationales that it advances to support its decision today. My brothers rightly conclude, and no one has asserted otherwise, that Caplin's claim against Marine could not "by the remotest stretch of language or even of imagination" be considered an action to "collect and reduce to money the property of the [estate] for which" Caplin is trustee, citing Section 47 of the

Bankruptcy Act. But it requires no lesser feat of linguistic gyration to conclude that the action in *Prudence-Bonds* was such an action. The action in *Prudence-Bonds* was one for an accounting for the loss to the bondholders, on behalf of the bondholders alone, that resulted from the indenture trustee's breach of a negative covenant, as here. It was not in any sense an action for restoration of the trust fund or the debtor's property (unless Caplin's action may also be so described). Indeed L. Hand specifically observed that "the breach was at most a failure properly to protect a part of the *res*"—which is precisely the situation here—"and not a 'surrender or release' " of the res. 202 F.2d at 559.

This is not the end of the majority's difficulties with *Prudence-Bonds*. My brothers go to great lengths to show —wrongly, I believe—that "other creditors or stockholders would not be affected" by Caplin's action in this case. But the reorganization in *Prudence-Bonds* has already been effected and would not likely to be altered retrospectively. Even had the suit been brought before a plan had been approved, the recovery would have inured to the benefit of no one but the bondholders, as is the case here.

There is a more fundamental answer, however, to the argument that only one class of creditors will be affected if Caplin recovers. Although the bondholders' recovery will swell directly only the purses of the bondholders, the majority ignores the central consideration that certainty as to the bondholders' rights against the indenture trustee cannot fail to affect the views of the interested parties and the court in passing on the fairness of the reorganization plan. 11 U.S.C. §621(2). The majority thus seems to misconstrue the true scope and nature of a reorganization proceeding. The process of reorganizing is not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed for-

mulas. Rather, the objective is carried out through a process of negotiation, and some give-and-take, in an attempt to adjust equitably and with sensitivity to the nuances of the individual case the rights of competing interested parties. As Judge L. Hand argued persuasively in dissenting from the decision in *Clarke*, the reorganization court has jurisdiction over a case such as this as part of its obligation to "adjust the mutual rights of the debtor's creditors as between themselves." 137 F.2d at 802. I see no reason for denying to the reorganization court, as the majority does, the power to discharge this obligation here or properly to perform its duty to adjudge the equitableness of a proposed reorganization plan.

This latter consideration is particularly relevant to this case, where it appears that the indenture trustee may be implicated in the causes for Webb & Knapp's bankruptcy. As Judge Hand put it, "the trustee should have prevented the debtor from siphoning its assets away from its creditors—the bondholders along with the other general creditors. . . . The loss was . . . of the debtor's assets; the remedy will be in their restoration; I do not understand how that can be alien to a reorganization." 137 F.2d at 802.

Thus, the parade of horribles which my brothers assert would follow if Caplin were allowed to bring this claim —including virtually the confiscation of property of parties with no semblance of due process—is a phantasm. We are concerned here only with the standing of a trustee in reorganization to *assert* the claims of creditors, not to *cancel* them, where the reorganization trustee asserts that creditors have been damaged along with all other parties to the reorganization by the indenture trustee's negligent failure to protect the debtor's assets. It is a very narrow proposition that the majority rejects, not an infinitely expandable one. By rejecting it, the majority retreats from this court's previously declared commitment to the flexible approach announced in *Prudence-Bonds*.

Moreover, the view of the majority appears significantly narrower than that of the *Clarke* majority. That court was unwilling to constrict itself to the narrow "property" analysis advanced by the majority, but suggested instead that the indenture trustee might have standing if "the claims for breach of the covenants [were] any part of the property of the bankrupt *or* would affect the plan of reorganization." (Emphasis added.) 137 F.2d at 800. Immediately following this sentence, the *Clarke* court launched upon an extended discussion of the question whether the claim would affect the plan after which it appended, almost as an afterthought, the observation that "Moreover the trustee . . . has no title to the claims embraced in the first and third counts . . . ." Although I believe that the *Clarke* majority was in error to hold that the claim would not affect the plan, its analysis was considerably broader than that adopted by my brothers.

Finally, the result today ill serves two reforms central to the scheme of the Chandler Act: to promote the collection and dissemination of all information relevant to the debtor and its affairs and to involve the Securities and Exchange Commission in complex reorganization proceedings as an advisor or friend of the court, a role it has assumed as a party to this appeal, in urging us to permit Caplin to pursue his claims. See H. Report No. 1409 on H.R. 8046, 75th Cong., 1st Sess., 47-48 (1937).

The reorganization trustee is empowered to undertake a comprehensive investigation into the history and financial condition of the debtor by 11 U.S.C. §567. To compel the bondholders in these circumstances to proceed individually or in a separate class action, would only give rise to a massive redundancy of fact-finding. To restate the point somewhat more positively, a fair adjudication of the issue between the bondholders and Marine will be promoted if

the information available to the trustee is efficiently brought to bear in that dispute and revealed to the court.[1]

Scrutiny or active participation by the SEC is provided for by numerous provisions of Chapter X (11 U.S.C. §§561, 567(5), 571-74, 590, 608, 622). On few issues is that agency's expertise more relevant than in a case such as this, involving the adjudication of rights and duties of a trustee functioning under the Trust Indenture Act of 1939, 15 U.S.C. §§77aaa *et seq.* This expertise will be available in a reorganization proceeding but ordinarily not in individual or class action bondholders' suits.

In short, today's decision not only retreats from past precedent but is contrary to the purposes which motivated Congress to enact the Chandler Act.

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[1] The manifest inconvenience of the *Clarke* rule is magnified in a case where, as here, the indenture trustee filed a claim against the estate of the debtor for his services as trustee. A determination of the merits of Caplin's plenary action and counter-claim will not require the bankruptcy court to investigate any matters that it would not have to pass upon in adjudicating Caplin's objection to Marine's claim.

Statutes Involved

Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, provides in part:

> "The judge may examine and disregard any provision of a * * * trust indenture * * * or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder * * *."

The Trust Indenture Act of 1939, 15 U.S.C. §§77aaa *et seq.*, provides in pertinent part:

> § 77bbb. Necessity for regulation
>
> (a) Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress pursuant to section 78jj of this title and otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected—
>
> (1) when the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors, notwithstanding the fact that (A) individual action by such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;
>
> (2) when the trustee does not have adequate rights and powers, or adequate duties and re-

sponsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures (A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and (B) generally relieve the trustee from liability even for its own negligent action or failure to act;

(b) Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public; and it is declared to be the policy of this subchapter, in accordance with which policy all the provisions of this subchapter shall be interpreted, to meet the problems and eliminate the practices, enumerated in this section, connected with such public offerings. May 27, 1933, c. 38, Title III, § 302, as added Aug. 3, 1939, c. 411, 53 Stat. 1150.

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§ 77ooo. Duties and responsibility of the trustee—Duties prior to default

(a) The indenture to be qualified may provide, that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn of this title to determine whether or not such evidence conforms to the requirements of the indenture.

* * * *

Responsibility of the Trustee

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts; and

* * * *

§ 77vvv. Court review of orders; jurisdiction of offenses and suits

* * * *

(b) Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 77v(a) of this title.